SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

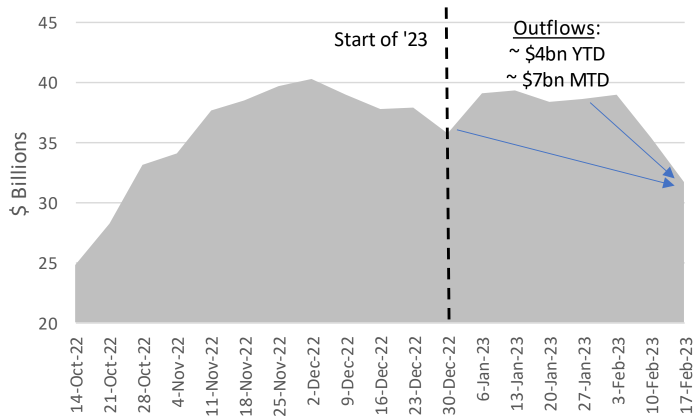
SKYView: When Technicals Turn

Credit markets have witnessed significant outflows since the start of the month, particularly among investment grade and high yield exchange-traded funds (ETFs). This dynamic has contributed to yield widening in our asset class, with larger / more liquid issues bearing a disproportionate amount of the pressure. Like most things, however, flows tend to be cyclical in nature. In this *Weekly Briefing*, we measure the magnitude of yield correction historically necessary to reverse acute outflow periods, leading us to conclude that market technicals may be on the verge of an inflection.

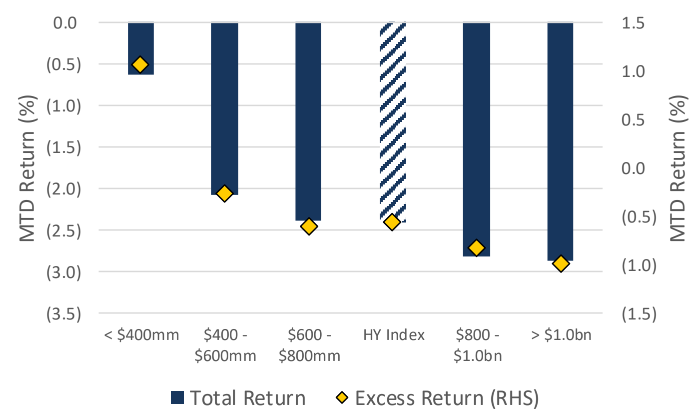
ETF Outflows Led to Large Issue Underperformance

In aggregate, four of the most prominent US high yield exchange-traded funds (tickers HYG, JNK, SHYG, and SJNK) have recorded sizeable outflows since the start of the month, with total fund assets down approximately $7bn (or 18% of AUM). **Technical pressure stemming from these outflows have contributed to negative total and excess returns thus far in February, offsetting a sizeable portion of January's gains**. As demonstrated below (right side), larger issues – which tend to be favored ETF holdings – have captured a disproportionate amount of the downside through the first three weeks of the month.

US High Yield ETFs Have Suffered Significant MTD Outflows
weekly data, total fund assets of HYG, JNK, SHYG, and SJNK



Outflows Have Most Negatively Impacted Large/Liquid Issues
data as of February 21, 2023

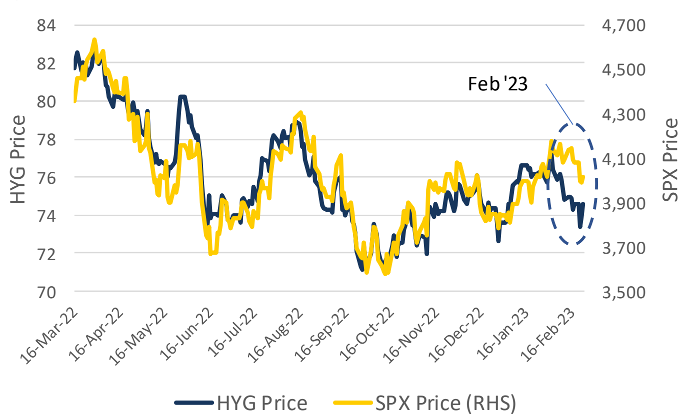


Source: SKY Harbor, Bloomberg, ICE Data Indices

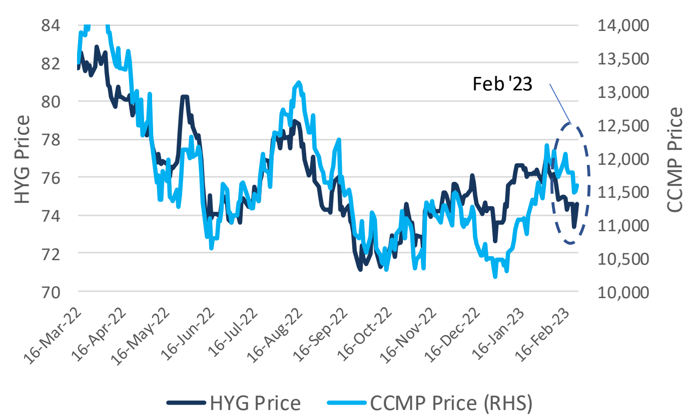
Correction Appears Overdone vs. Equities

There are signs, however, that the selloff in high yield ETFs may be overdone. As demonstrated below, **a strong historical correlation between iShares iBoxx High Yield Corporate Bond ETF (HYG) and S&P 500 (SPX) prices has recently broken down**. Though admittedly outside of our immediate area of focus, we have read research suggesting that recent short covering – particularly within the tech sector – has created a strong positive technical in equity markets that may largely explain the more recent divergence from credit. Not surprisingly, the same correlation breakdown can be seen when comparing HYG to the NASDAQ Composite. Without speculating if or when this dislocation will represent a relative value opportunity that could cause currently divergent technical trends to normalize, data below suggests corrections typically occur within short timeframes.

HYG Selloff More Severe Than S&P 500
daily data



HYG Selloff More Severe Than NASDAQ Composite
daily data



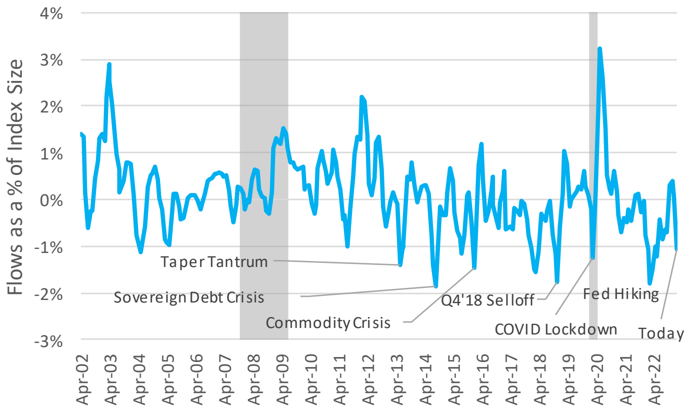
Source: SKY Harbor, Bloomberg, BofA Research

Yield Correction Appears Sufficient

As we have previously mentioned, and despite our best efforts, attempting to predict fund flows over the last decade has felt like a fool's errand. We have found some statistical support in attributing technicals to momentum, with trailing 1-week and 1-month total returns often coinciding with flows in the same direction. The predictive power of our analysis, however, has always been lacking. We have, however, found that <u>inflection points</u> in flows are a bit more grounded and based on observable data. This analysis, coupled with anecdotal evidence (conversations with asset allocators and the like), imply that **investors are often enticed back into high yield not when associated concerns have subsided, but when yields become sufficiently attractive to compensate for risks inherent to the asset class**. As demonstrated below, similarly severe outflow periods of the past have typically coincided with a rise in yield of 60 to 120 bps. Given a 110 bps increase in the yield-to-worst of the ICE BofA US High Yield Index (H0A0) from early February through the time of writing, the recent market correction appears sufficient for an inflection based on historical investor behavior.

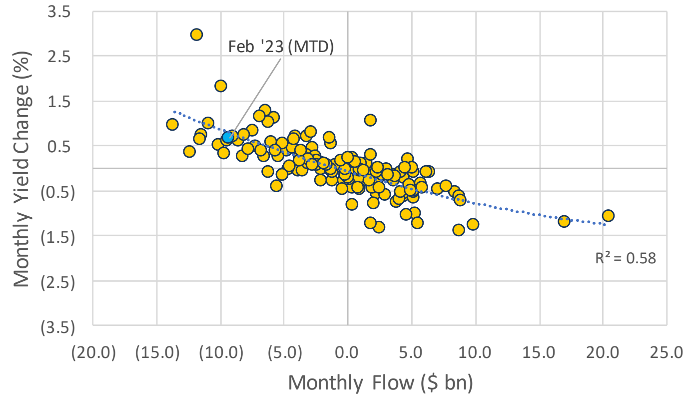
Adjusted for Index Size, Trailing 3-Mo Flows Now Bottom Decile

trailing 3-month flow as a percentage of HY face value, recessions in grey



Yields Have Reacted Accordingly

monthly data



Source: SKY Harbor, JP Morgan, Lipper

Waiting for Inflection

Market volatility and concerns over economic resilience in the face of further rate hikes were already on the rise when outflows began to accelerate in early February, all of which contributed to some moderation in year-to-date total returns. Technical pressure – seemingly most acute in the high yield and investment grade space – appears at odds with equity market activity, though observation of the dislocation provides little insight into the timing of an eventual normalization. Perhaps most encouragingly, an index yield-to-worst of approximately 8.9% is now approaching top-quartile levels, having corrected by an amount historically commensurate with outflow curtailment. As such, we believe significant high yield technical headwinds experienced during the month of February – most notable among popular exchange-traded funds – may begin to inflect in the coming weeks.

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